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SUMMARY

Eliminating state and local sales taxes on food would reduce funding for programs serving vulnerable children and families. The combined loss in local, state, and federal funding would be at least $631 million annually. Arkansas would lose at least $517 million in various state revenues and federal matching Medicaid funds. The federal loss does not even include potential funding lost from other programs, including child care, education or TEA/TANF. Local governments would lose $114 million.

Two of the state's largest funds — Public School and Human Services — would absorb 49 percent ($98 million annually) and 19 percent ($39 million annually), respectively, of the total general revenue cuts. The Arkansas Medicaid program would lose state and federal funding of $260.8 million annually ($23.2 million in state general revenue, $42 million in soda pop/trust fund revenue, and $195.6 million in federal matching funds).

Low-income taxpayers would not benefit from removing the sales tax on food as much as generally believed. If the food tax were eliminated, the bottom 20 percent of taxpayers would see a decline in their state and local tax burden of about $99 (1.3%) annually, while middle-income taxpayers would see a decline of about $254 (0.9%) annually. Taxes for the richest 1 percent of taxpayers would decrease by $769 (0.1%) annually. Only 8 percent of the benefits from eliminating the food tax would go to the poorest 20 percent of taxpayers. In contrast, 33 percent of the benefits would go to the richest 20 percent of taxpayers.

If the 2003 General Assembly decides to replace the lost revenue with an increase in the sales tax on non-food items, it would virtually offset any benefits from eliminating the food tax. The poorest 20 percent of taxpayers would see a decrease of only $25 annually, while middle-income taxpayers would see a decrease of only $15 annually.

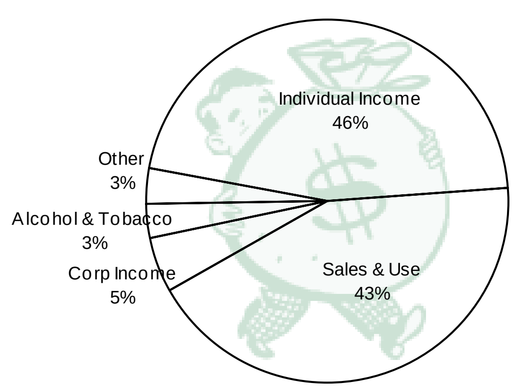
Would Abolishing the Food Tax Really Help Arkansas' Families?

By Richard Huddleston

This November, Arkansas voters may have the opportunity to decide a proposed constitutional amendment to abolish state and local taxes on food and medicine. The proposal comes at a critical time in Arkansas history. The Arkansas Supreme Court is on the verge of deciding the Lake View school-funding case, a decision which could require the state to raise $500 million to $1 billion in new revenue. An anticipated Medicaid-funding shortfall will place competing demands on the Arkansas budget. Regardless of whether the proposal is passed or rejected by the voters (if the courts leave it on the ballot), it's an issue unlikely to go away anytime soon. The Arkansas General Assembly will probably have to consider the issue in the 2003 legislative session.

To date, supporters and opponents of proposals to eliminate the food tax have made various claims about the potential impacts. But just what are the facts? Would abolishing the tax really help or hurt Arkansas families?

TAX SOURCES FOR GENERAL REVENUE
SFY 2003 Estimates



Source: AACF calculations from DF&A data.

The Food Tax and the State Tax System

The state general sales and use tax is a critical part of the Arkansas tax system. According to Department of Finance and Administration projections, Arkansas is expected to collect nearly $4.1 billion in gross general revenues during state fiscal year 2003. Sales taxes will comprise an estimated $1.7 billion (43%) of this amount, making it the second largest source of general revenue, behind individual income taxes (46%, or about $1.9 billion).

Food purchases are a critical part of the state sales-tax base.[1] Purchases of groceries represent 9.4 percent of state general sales tax collections. Purchases of food in restaurants represent another 4.3 percent of state sales tax collections. Together, <u>these food purchases comprise almost 14 percent of state general sales tax revenue, or about 6 percent of all state general revenue</u>.

Food purchases are also the most stable part of the sales-tax base. That is, food purchases are those least likely to vary with swings in the state or national economy. Unlike other consumer purchases, such as buying a new car or stereo, food is essential to one's day-to-day existence. Families must purchase food even when the economy worsens. For this reason, purchases of food, and the sales taxes collected when families purchase such items, are unlikely to decline from year to year.

What's the Revenue Impact?

The proposed amendment to abolish the state sales tax on food and medicine would have major impacts on state and local government tax revenues. While there is still legal uncertainty about whether the tax on certain items, such as purchases in restaurants, would be abolished, there is no doubt the impact on revenue would be significant. According to an analysis prepared by DF&A, the amendment could affect state and local government tax revenues in fiscal year 2004 in four ways:

1. *Grocery Purchases* The amendment abolishes the taxes on food for home consumption. All grocery purchases, with the exception of food-stamps purchases, would be exempt from sales tax. This would reduce state general revenue ($168.2 million), the one-eighth-cent conservation tax ($4.7 million), and the half-cent property tax relief fund ($18.7 million). It would also reduce local government revenues from the sales tax ($78.2 million). The loss of general revenue for the Department of Human Services Division of Medical Services would result in the loss of $47.7 million in federal matching Medicaid funds.

2. *Meals in Restaurants* It's still an open legal question whether the amendment would exempt purchases of meals in restaurants. The courts will have to decide whether a restaurant meal qualifies as "food for home consumption." If so, the revenue loss would be larger: state general revenue ($77.4 million), one-eighth-cent conservation tax ($2.1 million), half-cent property tax relief fund ($8.6 million), and local governments ($35.9 million). The loss of general revenue for the Division of Medical Services would result in the loss of another $21.9 million in federal matching Medicaid funds.

3. *Soda Pop* This is also an open legal question. If all taxes on food were eliminated, not just the sales tax, then the soft drink tax would be eliminated. This would include the tax paid by the wholesaler on bottled beverages, syrups and powders. The rev-

STATE and LOCAL REVENUE LOSS FROM PROPOSED CONSTITUTIONAL AMENDMENT[1]
In Millions

	Grocercies	Restaurants	All Food	Soda Pop	Medicine	TOTAL
STATE						
General Revenue	$168.2	$77.4	$245.6	-	TBE	$245.6
1/8-cent Conservation Fund	$4.7	$2.1	$6.8	-	TBE	$6.8
1/2-cent Property Tax Relief	$18.7	$8.6	$27.3	-	TBE	$27.3
Medicaid Trust Fund	-	-	-	$42.0	-	$42.0
Federal Medicaid Funds[2]	$47.7	$21.9	$69.6	$126.0	-	$195.6
LOCAL						
Regular Sales Tax	$78.2	$35.9	$114.1	-	TBE	$114.1
Hamburger Tax	-	TBE	-	-	-	TBE
TOTAL	**$317.5**	**$145.9**	**$463.4**	**$168.0**	**TBE**	**$631.4**

TBE = To Be Estimated
1. Does not include medicine or hamburger tax.
2. State general revenue Medicaid funds are matched 3:1. Includes federal funds lost from general revenue and soda pop.

Source: All data is DF&A except federar Medicaid loss from food, which is an AACF estimate.

enues from this tax are used as the state match for federal Medicaid funds at a 3:1 rate. The direct revenue impact on the state Medicaid match would be $42 million, and $126 million on federal matching funds.

4. *Medicine* The amendment would also eliminate any tax on medicine, currently defined as any item furnished or available at a reduced cost under a state or federal health-care assistance program. Prescription drugs are already exempt from the sales tax, so this would apply mainly to other medical supplies. DF&A has not yet estimated the revenue impact.

If the amendment passes and courts define the tax broadly to include grocery purchases, restaurant meals, soft drinks and medicine, the total revenue loss to Arkansas would be almost $631.4 million. This includes losses of $245.6 million in state general revenue, $195.6 million in federal Medicaid funds, and $114.1 million in local government funds.

How Would Revenues be Cut?
If the food tax were eliminated, the biggest loss would be in gross state general revenue, at $245.6 million in SFY 2004. After allowing for legislatively mandated set-asides taken off the top of state gross general revenues (roughly 18% of gross general revenues), the loss in state general revenues available for distribution to state agencies is $201.4 million.

If the 2003 General Assembly did not make any changes in each fund's share of state general revenue, the biggest losers would be the Public School Fund and the Human Services Fund. The Public School Fund would absorb 49 percent ($98 million) of the revenue loss from elimination of the food tax, while the Human Services Fund would absorb 19 percent ($39 million) of the loss.

Cuts in Human Services
One state agency hardest hit if the food tax were eliminated would be DHS. DHS is a large agency providing a wide array of services to families, including Medicaid, child care and early childhood education, juvenile justice, child welfare and mental health. Which DHS agencies would be hit the hardest? While DHS would likely have to re-arrange existing services priorities if the food tax were eliminated (and thus, agency shares of general revenue might change), the 2003 distribution of general revenue within DHS does provide clues as to which agencies might bear the brunt of any cuts.

Unless DHS changed the distribution of general revenue across agencies, the Division of Medical Services would take the largest hit. It would absorb 60 percent of the general revenue cut for DHS. Other agencies would also be hard hit. Five agencies – Mental Health, County Operations, Developmental Disability Services, Children & Family Services, and Youth Services – would each absorb about 6 to 8 percent of the cuts taken by DHS.

Losing Federal Matching Funds
The cuts in state general revenue, however, only tell part of the story. Some agencies, such as Medical Services, would take even bigger cuts because state general revenue is used to draw down federal matching funds (the Medicaid matching rate is 3:1). Medicaid would see dramatic, potentially catastrophic, cuts in funding and services for low-income children and families.

IMPACT ON GOVERNMENT OF REMOVING THE FOOD TAX
By Fund Account, SFY 2004

	% Share of Revenue Loss	Amount in Millions
Public School	48.5	$97.7
General Education[1]	2.0	$3.9
Higher Education	15.7	$31.7
Human Services	19.1	$38.6
General State Government[2]	10.1	$20.4
Others[3]	4.5	$9.1
TOTAL		**$201.4**

1. Includes departments of Education and Workforce Development, technical institutes, schools for the deaf and blind, rehabilitation services and libraries.
2. Includes funding for numerous state agencies, the largest of which are Correction and Community Punishment.
3. Includes miscellaneous funds, the largest of which are the Health Department, State Police, and county and municipal aid.

Source: AACF calculations based on DF&A data.

IMPACT ON DHS OF REMOVING THE FOOD TAX

	% of DHS General Revenue	Amount in Millions
Medical Services	60.1	$28.3
Mental Health	8.0	$3.1
County Operations	7.7	$3.0
Youth Services	6.5	$2.5
Developmental Disabilities	6.5	$2.5
Children & Family Services	6.0	$2.3
Administration	2.2	$0.8
Aging	1.7	$0.6
Child Care & Early Education	1.1	$0.4
Blind	0.3	$0.1
TOTAL		**$38.6**

Note: This table only reflects the general revenue loss. The actual loss for some agencies may be more because general revenue is used to match federal funds.

Source: AACF calculations based on DHS general revenue allocations for SFY2003.

Medicaid would lose about $23.2 million in state general revenue, plus $69.6 million in federal matching funds. In addition, Medicaid would lose $42 million in soda pop tax revenue going into the Medicaid Trust Fund, plus $126 million in federal matching funds. The total loss in state and federal Medicaid funding would be $260.8 million annually.

Will the Tax System be Fairer?
Supporters of the amendment to abolish taxes on food and medicine argue it would improve the fairness of the Arkansas tax system. But would it? The state's low-income taxpayers would not benefit as much as commonly believed (note: because of modeling limitations, this analysis is limited to food taxes, and does not include the effects of eliminating the tax on soda pop).

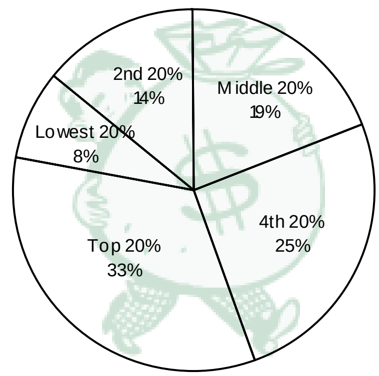
The poorest 20 percent of taxpayers would see their combined state and local tax burden decline by just over 1 percent ($99 annually). The second poorest taxpayers would see their tax burden decline by about 1 percent ($180 annually), while middle-income taxpayers would see their state and local taxes decline by just under 1 percent ($254 annually). The richest 1 percent of taxpayers would see a smaller percentage decline in their tax burden (only 0.1%), but would see the largest benefit in total dollar terms. Their taxes would go down by $769 annually.

Middle- and upper-income taxpayers would receive the lion's share of the total benefits from eliminating sales taxes on food in grocery stores and restaurants. The poorest 20 percent of taxpayers would receive only 8 percent of the total tax benefits from eliminating the tax on food. Middle-income taxpayers would receive 19 percent of the total benefits, while the richest 20 percent of taxpayers would receive one-third of the benefits from eliminating the taxes on food.

Why won't the state's poorest taxpayers benefit as much as commonly believed? Nearly 289,000 low-income Arkansans (about 10% of the state's population) use food stamps for some of their food purchases.[2] Under federal law, these purchases are exempt from state and local taxes. For many of these families, eliminating the sales tax on food would not reduce their tax burden.

Granted, many low-income families eligible for food stamps do not participate in the program (in Arkansas, only 66% of eligible families take advantage of the program).[3] And, for many of the families participating, food stamps does not cover all of their food purchases (the average food-stamps benefit per household was $173 in 2001 – which suggests about half of participating households received food-stamps benefits of less than $173).[4] Still, the high rate of food-stamps participation suggests

SHARE OF BENEFITS FROM FOOD TAX CUTS
By Income Level



Source: Institute on Taxation and Economic Policy, September 2002

IMPACT ON STATE MEDICAID PROGRAM OF REMOVING THE FOOD TAX
In Millions, SFY 2004

	Groceries + Restaurants	Soda Pop	TOTAL
State General Revenue	$23.2	-	$23.2
Medicaid Trust Fund	-	$42.0	$42.0
Federal Matching Funds	$69.6	$126.0	$195.6
TOTAL	**$92.8**	**$168.0**	**$260.8**

Source: AACF calculations based on DF&A and DHS data.

IMPACT ON FAMILIES OF REMOVING THE FOOD TAX ON GROCERIES and RESTAURANTS
All Arkansas Taxpayers, CY 2002

INCOME GROUP	Lowest 20%	2nd 20%	Middle 20%	4th 20%	Next 15%	Next 4%	Top 1%
INCOME RANGE	< $12,000	$12,000-$20,000	$20,000--$34,000	$34,000--$54,000	$54,000--$104,000	$104,000--241,000	> $241,000
AVERAGE INCOME	$7,400	$16,300	$26,900	$44,500	$73,200	$141,400	$574,600
Tax Change as Part of Income	-1.3%	-1.1%	-0.9%	-0.7%	-0.6%	-0.3%	-0.1%
Average Tax Change	$-99	$-180	$-254	$-327	$-408	$-473	$-769
Share of Total Tax Cut	8.0%	14.0%	19.0%	25.0%	23.0%	7.0%	3.0%

Source: Institute on Taxation and Economic Policy, September 2002 many of the poorest taxpayers who need tax relief wouldn't receive it by simply eliminating taxes on food.

What If Lost Revenue Were Replaced with Higher Sales Taxes?
In addition, some low-income taxpayers could be made worse off if the lost revenue were replaced, especially if replaced with higher sales taxes on other items. Such a scenario is very possible given constitutional restrictions on other taxes (many taxes require a three-fourths vote of the Legislature, while sales taxes only require a simple majority).

According to a new analysis, if the food tax were eliminated and replaced by a higher sales tax rate on other items, low-income taxpayers would see little change in their overall tax burden. The poorest 20 percent of taxpayers would see a net reduction of only $25 annually. The next poorest 20 percent would see a net reduction of only $17 annually, while middle-income taxpayers would see a net reduction of only $15 annually. The biggest change would be at the top end, as the richest 1 percent would see their burden increase by about $340 annually.

Do Other States Tax Food?
Forty-five states and the District of Columbia levy general sales taxes.[5] As of September 17, 2001, 35 states either completely or partially exempted food sales for home consumption or offset the tax through some type of credit or rebate. Of the 45 states with general sales taxes:

- Twenty-seven states and the District of Columbia completely exempt food for home consumption from the state general sales tax.
- Three states – Illinois, Missouri and Virginia – tax groceries at lower rates than other items subject to the sales tax.
- Five states – Idaho, Kansas, Oklahoma, South Dakota, and Wyoming – fully tax groceries but offer credits or rebates to offset some of the taxes paid by some parts of the population.
- Ten states fully tax food for home use without offering any type of relief for low-income families. These states include Arkansas, Alabama, Hawaii, Louisiana, Mississippi, New Mexico, South Carolina, Tennessee, Utah and West Virginia.

Many municipal governments levy their own sales taxes. When they do, they usually follow state policy in taxing food. The major exceptions are Arizona, Colorado, Georgia, and North Carolina — food purchases are exempt from state general sales taxes, but many municipalities continue to tax food.

What Does the Public Think?
Public opinion polls about eliminating the sales tax on food have been consistent over time. In 1999, the Arkansas Poll, conducted by the University of Arkansas, found more than 71 percent of Arkansans favor getting rid of the sales tax on food. An August 2002 poll conducted by Opinion Research Associates for Stephens Media came to a similar conclusion: 72 percent support the

IMPACT ON FAMILIES OF REMOVING THE FOOD TAX and REPLACING LOST REVENUE
All Arkansas Taxpayers, CY 2002

INCOME GROUP	Lowest 20%	2nd 20%	Middle 20%	4th 20%	Next 15%	Next 4%	Top 1%
INCOME RANGE	< $12,000	$12,000-$20,000	$20,000--$34,000	$34,000--$54,000	$54,000--$104,000	$104,000--241,000	> $241,000
AVERAGE INCOME	$7,400	$16,300	$26,900	$44,500	$73,200	$141,400	$574,600
EXEMPT GROCERIES AND RESTAURANTS							
Tax Change as Part of Income	-1.3%	-1.1%	-0.9%	-0.7%	-0.6%	-0.3%	-0.1%
Average Tax Change	$-99	$-180	$-254	$-327	$-408	$-473	$-769
Share of Total Tax Cut	8.0%	14.0%	19.0%	25.0%	23.0%	7.0%	3.0%
RAISE OTHER SALES TAXES TO COMPENSATE							
Tax Change as Part of Income	+1.0%	+1.0%	+0.9%	+0.6%	+0.5%	+0.3%	+0.2%
Average Tax Change	$+74	$+163	$+239	$+289	$+377	$+437	$+1,108
Share of Total Tax Hike	$6.0%	14.0%	20.0%	240%	24.0%	8.0%	5.0%
NET EFFECT ON FAMILIES							
Tax Change as Part of Income	-0.3%	-0.1%	-0.1%	-0.1%	-0.0%	-0.0%	+0.1%
Average Tax Change	$-25	$-17	$-15	$-38	$-38	$-37	$+340

Source: Institute on Taxation and Economic Policy, September 2002 proposed constitutional amendment to eliminate the sales tax on food and medicine. However, a more recent Stephens Media poll, conducted in September, found only 58 percent favored removing the sales tax on food. One question not asked of Arkansans is whether they would support eliminating the sales tax on food if it meant cutting vital public services, such as Medicaid, which benefits children and families.

Options for Tax Relief

In principle, it's hard to argue against eliminating the sales tax on food. It's one of life's most basic needs, and no family should ever be unable to afford it. Some would argue it is morally indefensible for any state to impose such a tax on its poorest citizens.

In practice, however, many of the poorest families (and those with the highest tax burdens) wouldn't benefit from the elimination of the sales tax. While some low-income working families (especially those not receiving food stamps) would benefit, others could be made worse off, especially if the state decided to replace the lost revenue with an increase in the sales tax rate on non-food items. Because everyone in the state would qualify for the tax cut, a large share of the financial benefits from eliminating the food tax would go to other groups.

Another concern is the impact on state revenue. Eliminating the food tax could further strain the state budget at a time when it can least afford it, especially with *Lake View* decision and a Medicaid-funding crisis on the horizon. The two state agencies most affected, the departments of Education and Human Services, provide critical services for low-income families which could be jeopardized if the revenue were not replaced.

While eliminating the sales tax on food has its pitfalls, the larger goal of reducing the tax burden on low-income families and making the tax system fairer is still a laudable one. The issue is how to do it without devastating the public services, such as education and health care, on which many low-income families depend. Fortunately, Arkansas does have options. Among the major ones:

1. *Establish a sales-tax rebate targeted at low-income families* Reducing the sales-tax burden on the poor is still a laudable idea. One option would be to establish a sales-tax rebate, targeted at low-income families, designed to offset part of their overall sales-tax burden. This would provide much-needed tax relief for the poor, but would not devastate the state treasury.

2. *Establish a state earned income tax credit (EITC)* Modeled after the successful federal EITC, state EITCs are designed to provide an income support for low-income working families, mostly with children. At present, 15 states have EITCs. The best EITCs are "refundable," meaning families receive a refund even if their credit is larger than their tax liability.

3. *Eliminate state income taxes for families with incomes below the federal poverty line* Arkansas imposes one of the highest state income tax burdens on families with incomes below the poverty line. Although the General Assembly raised the level at which families begin paying state income taxes to $15,600 in 1997, this is significantly below the current federal poverty line of $18,000. Arkansas could make the level at which families begin paying state income taxes equal to the federal poverty line and tie that level to future changes in the poverty line or inflation. This would, once and for all, remove poor families from the state income tax rolls.

These options, and others, will be discussed in upcoming reports to be issued by the Arkansas State Fiscal Analysis Initiative, a project of AACF. Stay tuned.

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For More Information

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